

OVERVIEW OF THE STATE OF TENNESSEE COLLATERAL POOL

PURPOSE

In March of 1990, the Tennessee General Assembly enacted legislation which permitted the creation of a statewide Collateral Pool. This legislation, known as “The Collateral Pool for Public Deposits Act of 1990”, was supported by financial institutions, the State Treasurer, Commissioner of Financial Institutions, and local government organizations.

The purpose of this legislation was to establish a collateral pool structure that would benefit financial institutions participating in the pool and local governments by allowing an alternative method of securing public funds that is efficient, cost effective, and safe. The Collateral Pool method of securing public deposits provides for a centralization of the collateral function in a pool administered by the Treasurer’s Office.

GOAL OF THE COLLATERAL POOL

The goal of the Collateral Pool Board is to operate a collateral pool system which offers a more efficient and less costly means to pledge collateral, and to provide a high level of risk reduction and control for financial institutions participating in the pool in a manner which is easy to understand and administer.

KEY FEATURES OF THE POOL

The Collateral Pool contains several key features. Participation in the pool is voluntary. Participation in the Collateral Pool is subject to application to and approval by the Collateral Pool Board.

Four financial institution Collateral Pool Board Members are appointed by the Treasurer from nominations submitted by the Tennessee Bankers Association Board of Directors. The other three members represent state and local government. Financial institutions participating in the pool coordinate activities with the Collateral Pool staff in the Treasurer’s office.

OBJECTIVES OF THE COLLATERAL POOL

1. To Minimize the Risk to Participating Financial Institutions.
 - a. The Board has established an admissions process and admission standards which ensure that only healthy financial institutions are permitted to participate.
 - b. The Board has established pledge levels for pool participants based on certain financial criteria of the institution.
 - c. Procedures have been established to cover “spike” situations for deposits that exceed the target pledge level.
 - d. Collateral securities are priced to market value on a regular basis.
 - e. A system has been established to monitor the financial condition of all pool participants to ensure the continued health of the collateral pool.

2. To Offer a More Efficient, Cost Effective Method for Collateralizing Public Deposits.
 - a. All collateral transactions for the pool will be processed through one public entity (State Treasury Department) using one statewide set of procedures.
 - b. Collateral securities must be pledged against an established monthly target pledge level thus eliminating multiple transactions.
 - c. Collateral securities can be pledged using one custody account instead of multiple accounts for each depositor.
 - d. The total amount of collateral needed to collateralize public deposits may be reduced by eliminating overpledging caused by multiple custody accounts.
 - e. Higher financial performance by participating financial institutions will be recognized in the Pool procedures by offering a lower pledge level to those higher performers.
 - f. The three pledge levels are 115%, 100%, or 90% as determined by financial performance and other criteria.
3. To Make Participation in the Collateral Pool as Easy as Possible for the Participants.
 - a. Reporting requirements will be kept to the minimum necessary while permitting monitoring of Financial Performance.
 - b. Uniform collateral pledging agreement will be used for all participants.
 - c. Uniform collateral pledging procedures will be used for all transactions.

FINANCIAL INSTITUTION LIABILITY

Participation in the Collateral pool is not without some risk. However, the pool is designed to limit any such potential risks.

By participating in the Collateral pool, a financial institution is required to sign a contingent liability agreement. This agreement essentially says that all financial institutions participating in the pool will guarantee the public depositors against the potential default of a participating financial institution. The financial institution's potential liability under this provision is limited to the percentage that its public deposits covered by the pool are to the total public deposits in the pool. For example, a financial institution having \$10 million in deposits in a total pool of \$1 billion would have a potential liability of one (1) percent of any loss.

The risk of loss itself is limited by two factors. First, the collateral pool board will admit financial institutions only after reviewing their financial condition to assure that the financial institution meets the minimum participation standards, and also monitors the financial institution's financial condition on a quarterly basis. Any financial institution that does not meet minimum participation standards, would not be a pool participant.

HOW THE COLLATERAL POOL WORKS

The Collateral Pool was established by legislation of the Tennessee General Assembly. Specific rules have been promulgated by the Collateral Pool Board to guide the administration of the Collateral Pool.

The Collateral Pool is an alternative method of collateralizing State of Tennessee public deposits. Public deposits addressed by this Pool include those of the State of Tennessee and Tennessee political subdivisions required by law to be collateralized. Examples of such deposits include funds belonging to the State of Tennessee, its departments, agencies, colleges, universities, technical schools, cities, counties, school districts, and local government utility districts.

Financial institutions who have applied and been accepted will determine the aggregate of their public funds accounts for the State of Tennessee and its political subdivisions. Collateral securities required to be pledged to protect those various deposit accounts will be pledged to the Treasurer of the State of Tennessee on behalf of the Collateral Pool. The securities pledged to protect these accounts will be pledged in the aggregate rather than against each individual account.

The amount of collateral required to secure these deposits is determined by a calculation described in the monthly deposit report prepared by the financial institution. The financial institution determines this amount monthly and the amount is referred to as the “target” or the “collateral target”. Each month, the Collateral Pool participant calculates the target and reports it to the Collateral Pool staff at the Treasury Department of the State of Tennessee. This report guides the financial institution through the calculation and reminds them that the target collateral should be pledged. Financial institutions pledge to their new target level monthly in conjunction with reporting. This reduces the number of transactions required for pledging.

Quarterly, an independent provider reports the financial criteria monitored by the Board. The Collateral Pool Board staff reviews this data and reports to the Board.

Routine pledging and releasing of collateral securities is performed by the Treasury Department staff in the Cash Management Division in their capacity as staff to the Collateral Pool Board. Reports and applications are received, reviewed, and processed by Treasury Department Collateral Pool Board staff prior to Board action. Correspondence will be handled by this staff experienced in collateral transactions. Routine questions are resolved by staff with the report preparer. Problems are referred to the Board on an as-needed basis.

Operational details are addressed in the attached rules summary and are further clarified in the official rules enclosed as Appendix B in the Operations Manual. The right to modify these procedures to insure efficient operations of the Collateral Pool is reserved. By making application to the Pool, the participant agrees to abide by the terms and conditions as established by the Collateral Pool Board. The participation agreement contains a contingent liability agreement as well as acknowledging the right of the Pool Board to assess participants for losses if any should occur.

RULE SUMMARY FOR THE STATE COLLATERAL POOL

This summary is designed to highlight the major points of the rules adopted by the Collateral Pool Board for the operation of the Collateral Pool. A copy of the Collateral Pool Rules is included in the Operations Manual for further detail. Please direct any questions relating to these rules to the Department of Treasury Collateral Pool staff at (615) 532-1168.

ADMISSION REQUIREMENTS

In March of 1990, legislation was passed authorizing the creation of a Collateral Pool (Tennessee Code Annotated, Title 9, Chapter 4, Part 5) to be administered by a Collateral Pool Board. This legislation empowered the Collateral Pool Board to establish admission criteria for determining pool participation. The Collateral Pool Board is comprised of seven members; namely, four financial institution members appointed by the State Treasurer, one local government representative, and two ex-officio members. The following criteria for admission to the Collateral Pool has been established.

The applicant must have a rating equal to or greater than fifteen (15) as determined from the most recent quarterly report published by Sheshunoff Information Services, Inc. (bank president's national peer group weighted rating) prior to application. Provided, however, the Collateral Pool Board may admit an applicant with a rating of less than fifteen (15) if it determines the applicant is otherwise financially sound.

The applicant must also meet or exceed the benchmark levels of three (3) out of the four (4) following financial ratios:

1. Primary Capital to Total Assets ratio – 5.5% minimum.
2. Total Capital to Total Assets – 6.0% minimum.
3. Regulatory (Tier 1) Capital – the minimum established in the applicable Federal Regulations, notwithstanding that the applicable regulator may have established a higher level for a particular applicant.
4. Regulatory (Tier 2) Capital – the minimum established in the applicable Federal Regulations, notwithstanding that the applicable regulator may have established a higher level for a particular applicant.

Any financial institution, as defined in Tennessee Code Annotated, Section 45-12-102, located in the state of Tennessee which is under the supervision of the Tennessee Department of Financial Institutions or the United States Comptroller of the Currency meeting the above criteria and completing the application as provided, shall be considered for admission to the Collateral Pool, subject to approval by the Collateral Pool Board. However, meeting these guidelines does not guarantee admission.

FINANCIAL STANDARDS FOR PARTICIPANT MONITORING

The Collateral Pool Board may consider any one, or any combination of the following guidelines for evaluating financial standards. The guidelines include, but are not limited to, the following benchmark levels.

1. Capital Adequacy Ratios:
 - a. Primary Capital to Total Assets
 - b. Total Capital to Total Assets
 - c. Regulatory (Tier 1) Capital – the minimum established in the applicable Federal Regulations, notwithstanding that the applicable regulator may have established a higher level for a particular participant.

- d. Regulatory (Tier 2) Capital — the minimum established in the applicable Federal Regulations, notwithstanding that the applicable regulator may have established a higher level for a particular applicant.
2. Asset Quality Ratios:
 - a. Loan Loss Allowance to Non-Performing Loans
 - b. Loans 90 Plus Days to Total Loans
 - c. Non-Performing Assets to Total Assets
3. Earnings Ratio:

Return on Average Assets (Annualized)
4. Liquidity Ratio:

Total Loans to Total Assets
5. Sheshunoff Rating:

A rating (bank president's national peer group weighted rating) as determined from the most recent quarterly report published by Sheshunoff Information Services, Inc.

The Board may consider such other financial information as it deems necessary or appropriate.

DETERMINATION OF COLLATERAL PLEDGE LEVEL

The collateral pledge level to be used by each Collateral Pool participant to arrive at their pledge target may be determined on a percentage basis using the following factors:

1. If the Total Collateral Pool participants hold an aggregate of less than thirty percent (30%) of the total sum of deposits held in the State of Tennessee by financial institutions, the collateral pledging level shall equal two hundred percent (200%).
2. If the Total Collateral Pool participants hold an aggregate of thirty percent (30%) or more of the total sum of deposits held in the State of Tennessee by financial institutions, the collateral pledging level shall equal one hundred fifteen percent (115%).
3. However, the collateral pledging level will be one hundred percent (100%) for any participant whose bank rating is equal to or greater than twenty-five (25) as determined from the most recent quarterly report published by Sheshunoff Information Services, Inc. (bank president's national peer group weighted rating) and meets or exceeds at least seven (7) of the nine (9) benchmark levels as set forth in the previous section. The collateral pledge level will be ninety percent (90%) if the participant meets the requirement in Rule 1700-4-1-.04(1)(b). The Rules and Regulations are contained in Appendix B.

Each pool participant is required to maintain, at a minimum, pledged collateral with a minimum market value of one hundred thousand dollars (\$100,000).

The Collateral Pool Board has also identified certain situations that may affect a pool participant's pledge level. These specific circumstances follow:

1. A participant who holds deposits in excess of its capital, surplus, and undivided profits may be required to use a higher pledge level to collateralize this excess amount.
2. A participant who holds deposits in excess of ten percent (10%) of the total deposit base of the collateral pool may be required to pledge the excess deposit amount at a higher level.
3. Any participant who has been operating for less than three (3) years may be required to pledge at a higher level.
4. Deposit Spiking Requirement: A pool participant will calculate a monthly required collateral target minimum level to pledge collateral against. In addition, the pool participant will monitor its daily public deposits to ensure that the total amount of public deposits held DOES NOT EXCEED the participant's monthly collateral target level by twenty-five percent (25%). Should an excess occur, the participant is required to pledge the additional collateral to cover these excess deposits within two (2) business days. The additional collateral is not required if the excess funds are withdrawn within the two (2) day requirement.

REPORTING REQUIREMENTS FOR PARTICIPANTS

Examples of the required reports and detailed instructions for completing these reports appear in Appendix C of this Operations Manual.

1. Application for Admission to the Collateral Pool.

Each financial institution that wishes to participate in the Collateral Pool to secure public deposits must complete an application and provide the data requested. After the completed application has been reviewed, it will be acted on by the Collateral Pool Board at a Collateral Pool Board meeting. (Appendix C, page C-1)

2. Monthly Depository Collateral Reports.

Every pool participant is required to file a completed monthly report of deposits by the fifteenth (15th) day after the end of each calendar month. A copy of the monthly report and the instructions for completing the report are included in this Operations Manual. (Appendix C, page C-13)

3. Annual Certification Reports.

Annually, every pool participant is required to file a management certification and a certification by independent auditors. The report must be filed by March 31 of each calendar year and include the required information for the prior calendar year. A copy of the annual report and the instructions for completing the report are included in this Operations Manual. (Appendix C, page C-26)

4. Amended Reports.

If a pool participant determines that an inaccurate or incomplete report has been filed, an amended report must be filed within the following time frames:

- a. Monthly Deposit – Not later than ten (10) business days after it has been determined that the prior report was inaccurate or incomplete.

- b. Annual Report — Not later than fifteen (15) business days after it has been determined that the prior report was inaccurate or incomplete.

5. Notice of Change.

Pool participants will complete this form whenever they experience a change of ownership, name, charter, or address. (Appendix C, page C-30)

6. Supplemental Reports

The Board may request, in writing, any financial information it deems necessary from a pool participant that may be needed for the effective operation or continued safety of the Collateral Pool. The pool participant is required to supply the requested information not later than five (5) business days from receipt of the request.

ENFORCEMENT ACTIONS

To assure that the Pool operates safely, the Board has been given powers to enforce compliance with the statutes and rules.

1. Cease and Desist Orders.

If the Board has reason to believe that a pool participant is violating any of the provisions specified in the Collateral Pool for Public Deposits Act or within the Collateral Pool Rules, the Board may issue an order to cease and desist from the violation. The participant will be notified of the order within five (5) business days. The cease and desist order may contain any terms or conditions that the Board feels are appropriate to correct the violation. Any participant may appeal a cease and desist order by following the appeal procedure found within the Collateral Pool Rules.

2. Suspension.

The Board may suspend or disqualify any pool participant from the Collateral Pool for violation of any order issued by the Board or for any violation of the provisions of the Act or the Collateral Pool Rules. The participant will be notified within ten (10) business days of any suspension action taken by the Board. This notice will include the effective date of the suspension, the length of the suspension, and any terms or conditions of the suspension as determined by the Board. The participant is required to supply the State Treasurer's office a current listing of all public depositors within five (5) business days of receipt of the notice of suspension.

3. Mandatory Withdrawal.

A pool participant shall be required to withdraw from the pool upon a majority vote of the Board. A participant shall continue to maintain pledged collateral in an amount established by the Board to ensure that the withdrawing participant can continue to meet its contingent liability as stated in the pool contingent liability agreement.

PAYMENT OF LOSSES

In the event of multiple default or insolvency by pool participants, the claims of public depositors will have priority based on the date of the default or insolvency. Claims arising from a default or insolvency occurring

earliest in time will have priority over claims arising subsequently. The State Treasurer will pay public depositors based on this priority.

COLLATERAL POOL FEES

The State Treasurer's office will furnish to the Collateral Pool Board the estimated amount required to operate the collateral pool for each year. Pool participants will be assessed a share of this amount as determined by the following guidelines:

1. If the pool participants hold an aggregate of thirty percent (30%) or more of the sum total of deposits held in the State of Tennessee by financial institutions, the percentage of the estimated cost to be assessed will equal zero percent (0%).
2. If the pool participants hold an aggregate of less than thirty percent (30%) of the sum total of deposits held in the State of Tennessee by financial institutions, the percentage of the estimated cost to be assessed will equal one hundred percent (100%).

The sum total of deposits held by financial institutions in the State of Tennessee and the sum total of deposits held by pool participants will be determined from the most recent quarterly report published by Sheshunoff Information Services, Inc.

The estimated cost will be assessed to all pool participants on a prorated basis. The assessment for each participant will be determined by multiplying the estimated cost by the percentage of public deposits in the collateral pool held by the participant. The fees are required to be paid within thirty (30) days of notice of assessment from the State Treasurer's office. If the Board determines that the resources available to the collateral pool are not sufficient to operate the pool, the Board may increase the amount of fees to be assessed against the pool participants.

VOLUNTARY WITHDRAWAL FROM THE POOL

Should a participant decide to withdraw from the collateral pool, the following conditions must be met before the withdrawal is effective:

1. Written Notice.

The participant must give written notice to the State Treasurer's office and to all public depositors having deposits within the participant's financial institution. The notice will give an effective date of the withdrawal, which date cannot be less than one hundred eighty (180) calendar days after the notice is received by the Treasurer.

2. Contingent Liability.

The participant will continue to be contingently liable for any pool losses for the period of time stated in the Depository Pledge and Contingent Liability Agreement. In addition, the participant will maintain sufficient collateral to meet its contingent liability as provided in said Agreement.

3. Reports.

The withdrawing participant must continue to file all the required pool reports during the period in which the contingent liability agreement is in effect.

COLLATERAL POOL BOARD RULES

A copy of the Collateral Pool Board Rules are contained in Appendix B hereof. The Rules cover each of the preceding topics in greater detail.

GENERAL INFORMATION

Treasury Department, State of Tennessee staff provides support to the Collateral Pool Board. All applications, forms, and inquiries are to be directed to the following:

Mailing Address:

**Treasury Department
Collateral Pool Board
P.O. Box 198785
Nashville, TN 37219-8785
(615) 532-1168**

Overnight Delivery Address:

**Treasury Department
Collateral Pool Board
500 Deaderick Street
11th Floor Andrew Jackson State Office Building
Nashville, TN 37219
(615) 532-1168**